COMMONWEALTH OF VIRGINIA

At Richmond, DECEMBER 22, 1998

APPLICATION OF

VIRGINIA–AMERICAN WATER COMPANY CASE NO. PUE970523

For a general increase in rates

ORDER ON HEARING EXAMINER'S REPORT

On June 6, 1997, Virginia–American Water Company ("Virginia–American" or "the Company") filed an application requesting a general increase in rates. In its application, the Company requested an increase of $1,838,979, or a 7.30% increase, in total annual operating revenues, based on a test year ending December 31, 1996. The Company later reduced its requested increase in revenue requirement to $938,009.

By Order dated June 27, 1997, the Commission accepted the proposed tariff revisions on an interim basis, subject to refund with interest, effective for service rendered on and after November 3, 1997. That order also set the matter for hearing; established a procedural schedule for the filing of pleadings, testimony and exhibits; and appointed a hearing examiner to conduct all further proceedings.

The hearing was convened on January 21, 1998, before Hearing Examiner Howard D. Anderson, Jr. Counsel appearing were: Richard D. Gary for the Company; Edward L. Flippen for the City of Hopewell ("Hopewell"); John F. Dudley for the Hopewell Committee for Fair Water Rates ("Committee"); and William H. Chambliss and Marta B. Curtis for the Commission's Staff.

Prior to the hearing, an agreement was reached on certain accounting adjustments and cost of equity issues. At the hearing, certain other accounting issues and issues relating to the

Company's cost of service and rate design in the Hopewell operating district remained in controversy. Specifically, the Company disagreed with Staff's proposed parent debt adjustment ("PDA"), consolidated tax savings adjustment, and allocation of a portion of the Dinwiddie Avenue storage tank to a non-jurisdictional customer, Fort Lee. The Company also disagreed with Staff's allocation of a portion of the Company's domestic transmission and distribution mains to the Prince George County Service Authority.

Hopewell generally supported Staff's accounting adjustments with the exception of adjustments regarding waste disposal and affiliate expenses, but took no position on Staff's consolidated tax savings adjustment. The Company disagreed with Hopewell's proposed wastewater adjustment and its adjustment eliminating affiliate expenses in the Hopewell operating district.

The Committee disagreed with the Company's jurisdictional cost of service study for the Hopewell operating district and with Staff's and Hopewell's allocation of expenses and rate base associated with the new filters and the clearwell. The Committee contended that the Company's cost of service study underestimates its non-jurisdictional load (specifically, the maximum day demand for Fort Lee) and that industrial customers should not be allocated a significant portion of costs associated with the new filters and the clearwell.

On August 27, 1998, the Hearing Examiner filed his Report. Based on the evidence in the proceeding, the Examiner found that:

(1) The twelve months ending December 31, 1996, was an appropriate test period for this case;

(2) The Company's test year operating revenues, after all adjustments, were $25,236,174;

(3) The Company's test year operating revenue deductions, after all adjustments, were $20,208,911;

(4) The Company's test year net operating income and adjusted net operating income, after all adjustments, were $5,027,263 and $5,019,936, respectively;

(5) The Staff's proposed accounting recommendations and adjustments, except as modified by the Examiner, were just and reasonable and should be adopted;

(6) The Company should provide journal entries documenting its compliance with Staff's booking recommendations within sixty days of the issuance of a final order in this case;

(7) The points of agreement on accounting issues reached between Staff and the Company were reasonable and should be adopted;

(8) The Company's current rates produced a return on adjusted end of test period rate base of 8.52%, and a return on equity of 8.85%;

(9) The Company's current cost of equity is between 10.25% and 11.25%, and the midpoint of the range, 10.75%, should be used to calculate the Company's overall cost of capital and revenue deficiency;

(10) The Company's overall cost of capital, based on the December 31, 1996 capital structure of Virginia-American and a 10.750% cost of equity, was 9.353%;

(11) The Company's end of test period rate base, after all adjustments, was $58,900,613;

(12) The Company required additional gross annual revenues of $776,251 to earn a reasonable rate of return on rate base;

(13) The $776,251 rate increase should be allocated as follows: Alexandria - $171,912; Hopewell - $329,596; Prince William - $274,743;

(14) The Company's rate design and terms and conditions of service should be modified in accordance with the recommendations contained in the Report;

(15) The Company should file permanent rates designed to produce the additional revenues found reasonable using the revenue apportionment methodology recommended in this Report;

(16) The Company, in the future, should be required to present all pro forma adjustments on a total District basis and then allocate the adjusted amounts to jurisdictional and non-jurisdictional business;

(17) The Company should be required to refund promptly, with interest, all revenues collected under its interim rates, effective November 3, 1997, in excess of the amount found just and reasonable; and

(18) Interest upon the refunds should be computed from the date payment of each monthly bill was due during the period the interim rates were in effect and subject to refund until the date the refunds are made, at an average prime rate for each calendar quarter. The applicable average prime rate shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin, or in the Federal Reserve's "Selected Interest Rates" (Statistical Release G.13), for the three months of the preceding calendar quarter.

Virginia-American filed exceptions to the Hearing Examiner's Report. The Company takes exception to the Examiner's recommendation that the parent debt adjustment be continued in this case. Virginia-American requests that, in the event the Commission does continue this adjustment, the Company be allowed to make a parallel adjustment to incorporate certain costs incurred by the parent company, American Water Works ("AWW"), in raising debt.

The Company also objects to the Examiner's recommendation that the customary interest rate on refunds be applied in this case. The Company seeks to apply its average short-term borrowing rate (approximately 6.0% during the period November, 1997, when the interim rates became effective, until March, 1998) in calculating interest on refunds rather than the prime interest rate for each calendar quarter traditionally required by the Commission, which has averaged 8.5% during the same period. The Company states that because the additional revenues produced by the interim rates effectively replace only short-term borrowings, the short term borrowing rate is appropriate to use to calculate refunds.

Staff filed comments on and exceptions to the Examiner's Report. Staff takes exception to the Examiner's recommendation that Staff's proposed consolidated tax adjustment ("CTA") be rejected. Contrary to the Examiner's finding, Staff maintains that adopting the CTA would not constitute retroactive ratemaking because the adjustment would not result in the refund of any

rates effective for past periods; rather, it would merely compute a current return on an item that cumulates over time. Staff states that AWW, by filing consolidated federal tax returns rather than individual returns for each subsidiary, has enjoyed cash tax benefits that would not have been available to it but for Virginia-America's positive tax liabilities. Staff states that Virginia-American ratepayers have provided an uncompensated cash subsidy to AWW and, therefore, it is logical and equitable that the ratepayers should be allocated a return on the parent company's tax savings in an amount proportional to Virginia-American's responsibility for the savings.

Staff agreed with the Examiner that it was proper to include an adjustment for parent company debt. Staff also agreed with the Examiner that the parent company expenses should not be included in that adjustment, but for a different reason than that expressed by the Examiner.

Hopewell objects to the Examiner's finding that the Company's affiliate expenses should be approved. Hopewell contends that, based on the facts of this case, the Examiner misapplied the law. More specifically, Hopewell states that, under Commonwealth Gas Services, Inc. v. Reynolds Metal Co., 236 Va. 362 (1988) ("Reynolds"), the Company has the burden of showing that any affiliate expense that is included in rates is reasonable, but Virginia-American offered no evidence as to the reasonableness of the affiliate charges in this case. Hopewell also argues that the Examiner's reliance on the Commission's decision finding affiliate expenses reasonable in its last rate case is unavailing. Hopewell points out that the affiliate charges at issue in this case are different than the charges litigated in the Company's last rate case and § 56-235.3 of the Code of Virginia requires that each case must be decided based on the facts presented in that case.

The Committee filed comments in which it took exception to certain of the Examiner's findings concerning allocation issues. The Committee contends that the allocation of 85% of the new filters and clearwell to the industrial class is unreasonable and maintains that only one-third of the clearwell should be allocated to the industrial customers. In support of their proposal, the Committee states the industrial customers receive service through a separate filtration system and only domestic customers are served by the new filters; the industrial customers are allocated

100% of the costs of the wood tubs and the separate clearwell; and the only benefit to the industrial class from the clearwell is increased reliability. The Committee also objects to the Examiner's recommended allocation between jurisdictional and non-jurisdictional customers of the Dinwiddie Avenue Tank. The Committee argues that the Staff and the Examiner simply accepted the Company's estimate of Fort Lee's maximum day demand as reasonable, but that number is, in fact, understated. The Committee requests that the Commission order Virginia-American to install a meter for Fort Lee as soon as possible to measure and record actual maximum daily demand.

In addition, the Committee supports the adoption of the parent debt adjustment, but requests that the Commission require the use of an allocator based on stockholders' equity compared to the total equity of the parent.

NOW THE COMMISSION, having considered the record, the Examiner's Report and the comments and exceptions thereto, is of the opinion and finds that the Examiner's findings and recommendations should be adopted, except as modified herein.

As stated, the Examiner approved Staff's proposed parent debt adjustment on the basis that he found no reason to depart from the Commission's decision on this issue in Virginia-American's last rate case. In addition, he rejected the Company's proposal to include in the PDA certain expenses incurred by AWW in raising the debt because the Company did not quantify such costs. We agree with the Examiner that the PDA should continue to be applied. As stated by the Examiner, we have approved the same adjustment for this company in the past, and the Company raises no new arguments in its comments on the Hearing Examiner's Report that persuade us otherwise.

We will also deny the Company's request that it be allowed to include in the PDA the costs incurred by AWW in raising and maintaining the debt. The Company argues that the PDA allocates all of the tax benefits associated with the AWW interest deduction related to the Company, "while simultaneously allocating none of the related costs." The Company then seeks to allocate a share of AWW's costs required to issue and maintain current outstanding bonds.

These activities may include, among other items, providing reports and financial material to current and prospective bondholders.[1] The Company's proposal cannot be accepted; AWW, as the shareholder of the Company, is already being compensated for those and other costs of AWW's investment in the Company by the equity return allowed the Company.

At the heart of the PDA is the acknowledgment that the equity investment of AWW in the Company is financed by a combination of equity and debt issued by AWW. The equity return authorized for the Company (10.75% in this case) covers not only the part of AWW's investment in the Company financed by equity, but also that part of AWW's investment that is financed by debt. This is an advantage to AWW because the part of its equity investment in the Company financed by debt may cost substantially less than the allowed equity return. What the PDA does is give the Company's ratepayers the benefit of the tax deduction for the interest paid on that part of AWW's investment in the Company financed by debt. The expenses of AWW required to issue and maintain current bonds and stock, including interest and dividends, are AWW expenses and are covered by the 10.75% allowed return.

Turning to Staff's proposed consolidated tax adjustment, we decline to adopt Staff's proposed CTA in view of the circumstances of this case. In particular, we have concerns stemming from the parent company's history of relying on the cash flow that has been available to it by virtue of filing a consolidated federal tax return.[2] While we will not adopt this adjustment at this time for this company, we do not rule out the possibility of adopting it in the future in appropriate circumstances.

As stated, Hopewell strongly objects to the Examiner's finding that the affiliate expenses in this case should be approved. Hopewell alleges that the transactions underlying the affiliate charges at issue in this case are different than the transactions at issue in the Company's last rate case and contends that the Examiner erred in relying upon the Commission's approval of

[1] Exceptions of Virginia-American Water Company to Hearing Examiner's Report at 6-7.
[2] Our decision is not based on the Examiner's suggestion that Staff's proposed CTA may constitute retroactive ratemaking and we specifically decline to rule on that issue.

Virginia-American's affiliate expenses in its last case. Hopewell argues that Virginia-American has not carried its burden of proof that the affiliate expenses in this case are reasonable.

We agree with Hopewell that the Company has not met the standard set forth by the Virginia Supreme Court in Reynolds. In that case, the Court found that the company's reliance on a service agreement previously approved by the Commission and the Commission's approval of a company's affiliate expenses in a prior rate case were not sufficient to prove the reasonableness of the affiliate costs at issue. Pointing out that the utility had "presented no evidence of comparative prices or affiliates profits," the Court stated that the utility has an affirmative burden to show that affiliate costs are reasonable and merely itemizing the expenses or describing how the company reviews and pays the bills does not meet that burden.[3] Upon reviewing the record, we agree with Hopewell that Virginia-American has done nothing more than itemize the affiliate costs which, clearly, under Reynolds, is not enough. Further, the mere fact that "no profit" is included in the charges does not make the charges reasonable. Therefore, we will remand this issue, and this issue only, to the Examiner to give the Company an additional opportunity to present evidence as to the reasonableness of the affiliate expenses for which it seeks recovery in this case.

In remanding the affiliate expense aspect of this case, we make two additional points. First, we do not intend to remand future cases for this or any other company. Each utility should know the burden of proof it must meet with respect to affiliate expenses, including a showing that such expenses are reasonable. In the future, those companies that fail to meet that burden in full may expect to have the expenses disallowed rather than having an additional opportunity as we are providing here. Second, while outside consultants or witnesses may be necessary from time to time with respect to affiliate expenses, we are not stating that such consultants or experts are necessary in every or even any case. The company simply must meet its burden of proof.

[3] Reynolds, 236 Va. at 367.

With respect to the allocation issues raised by the Committee, we will adopt the Examiner's findings and recommendations, with one minor modification. We agree with Staff that there is no compelling reason to undo the allocation of the carbon contactors, new filters and the new clearwell that the Commission had found to be reasonable in Virginia-American's last rate case (in PUE950003).[4] We will, however, allocate 15% of the industrial clearwell to the domestic class since, currently, the industrial class is allocated 85% of the new filters, new clearwell and the carbon contactors, while domestic customers are not allocated any portion of the costs of the industrial clearwell. This will result in a symmetrical sharing between the two classes in this regard.

We also will not adopt the Committee's request that the Company be ordered to install a time-of-use meter for Fort Lee that will measure and record actual maximum daily demand. We agree with Staff that the cost of a time-of-use meter is not warranted because gathering maximum day demand data for only Fort Lee would not be helpful without gathering the same data for all other customer classes.

Finally, Virginia-American takes exception to the Examiner's finding regarding the interest rate to be applied in calculating refunds. As discussed above, the Company contends that it should be allowed to use its average short-term borrowing rate, rather than the average prime rate for each calendar quarter that the Commission customarily requires. In support of its request, the Company states in its Exceptions:

> Since these additional revenues effectively replaced short term borrowings, this short term rate is more appropriate to use for refunds than the prime rate.[5]

This statement misses the point. First, the Company should never consider excess charges as a replacement for short term borrowings. Second, our primary concern is not the Company's cost, but rather the ratepayers' cost. It is the ratepayer that has been required to

[4] Application of Virginia-American Water Co., 1997 S.C.C. Ann. Rept. 333.
[5] Exceptions of Virginia-American Water Company to Hearing Examiner's Report at 8.

make payments determined to be in excess of those that are just and reasonable. The prime rate is certainly fair; few customers could borrow at that rate and the lost opportunity cost might well be above prime. We must deny the Company's request. Accordingly,

IT IS ORDERED that:

(1) The Examiner's findings and recommendations are adopted, except as modified in the body of the Order and with the exception of the issue of affiliate expenses.

(2) The matter of the reasonableness of Virginia-American's affiliate expenses sought to be recovered in this case is hereby remanded to the Hearing Examiner for further consideration, as discussed herein.

(3) This matter will be continued generally pending the results of the remand ordered herein.

MOORE, Commissioner, concurs in part and dissents in part:

I concur with my colleagues, except with respect to the consolidated tax adjustment ("CTA"). Virginia-American's rates reflect a higher tax than the parent company will actually have to pay on a consolidated basis because of losses in the parent's operations. Therefore, the reality is that the parent has and will continue to enjoy the use of, in essence, cost-free capital. I believe that it is only fair that Virginia ratepayers be compensated for the use of this capital by providing them a return on that capital.

I agree with my colleagues that the Company has relied on the availability of the cost-free capital in the past and I would not adopt the CTA as proposed by Staff. I would, however, adopt the adjustment on a prospective basis. Adopting the CTA on a prospective basis would allow the Company to continue to use, cost free, the capital provided in the past and require the Company to compensate ratepayers for their contribution to AWW's cash tax benefits, prospectively.

Ratemaking is at its best when utilities can most accurately track the costs associated with providing service. Adopting the CTA would more accurately reflect the Company's actual cost of providing service.